

Pipelines and Pipe Dreams

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Things are looking up for Russia. In late August, Prime Minister Vladimir Putin finally opened a new pipeline exporting East Siberian oil to China. Dubbed the Eastern Siberia-Pacific Ocean pipeline, or ESPO, the plan is to pump 1.6 million barrels per day toward the Pacific Ocean over the next few years. The rationale is clear. Diversifying supplies to Asia offers Russia the Holy Grail that all energy producers want — leverage over competing consumers in the East and West.

The fact that Moscow is slated to send more than 300,000 bpd to China through ESPO extensions next year should come as ominous news for Europe. Russia will get top prices for the Skovorodino-Daqing pipeline and will push for ESPO crude to set a new benchmark price for the Asia-Pacific region. Rosneft certainly has China National Petroleum Corporation, or CNPC, China's largest oil and gas producer, firmly nailed down. CNPC sank \$25 billion into the project in return for a 20-year supply agreement.

With China developing a taste for Russian oil, we can expect gas to follow. The political infrastructure is partially in place under a memorandum of understanding struck between

Gazprom and CNPC in 2006. Pricing formulas have been the main stumbling block so far, but things could still come together. China knows its gas demand is rapidly rising, while Russia will be more flexible on pricing provided it can maintain some kind of oil price link. It knows that China can draw on Turkmen and Australian supplies to fill the gaps in the short term, and that failure to become Beijing's supplier of choice would be a costly mistake. It would create additional Asian price pressures from Japan and South Korea and allow European consumers to drive gas prices down further.

Moscow needs little reminding that oil price links are looking decidedly shaky. But if Russia managed to feed the Chinese gas market, this narrative would be turned on its head. Moscow would be well-placed to set price, volumes and the associated political terms to consumers in the East and West. It would also do so when markets have tightened, probably about 2014.

Many politicians in Brussels are fearful of precisely this prospect. The doomsday scenario is if Russia links Sakhalin and East Siberian reserves with West Siberian fields. This would give Moscow the choice of liquefied natural gas or pipeline exports, alongside far greater flexibility to feed gas markets in both the East and West. If efforts to collude on gas prices with other European suppliers are intensified and control of Central Asian exports routes under Russian tutelage are tightened, the outlook for European consumers will be very bleak.

In addition, Russian upstream investments in West Africa and major new pipelines such as Nord Stream could redefine the energy-security configuration in Eastern Europe. Will this amount to a gas cartel? Probably not, but it should be taken as a given that we will see more encirclement toward and price collusion among key producers. The latest gas deal between Russia and Azerbaijan is a case in point.

At the same time, though, Russian "arbitrage" won't come that easily. Geography is one major problem. Hydrocarbons are spread too far across Russia to ever bring them under one truly integrated grid. The second problem is a chronic lack of investment. Beyond Gazprom's blustering, the Kremlin failed to invest during the energy good times where it mattered most — in Russia itself. Oil and gas production is now likely to face depletion as a result.

Attracting increased foreign investment could help offset this to some degree, but here's the final rub: If Moscow fails to resist the temptation of playing off competing Asian and European markets before the pipelines are welded and fields flow, consumers might realize that investing in upstream Russian assets is not in their best interests.

In the end, consumers in Europe and Asia should be focusing much more on reducing their energy demands, integrating grids, improving efficiency and developing alternative energy sources. Otherwise, Putin will return to his energy pedestal, which means that his policy of energy blackmail that we saw so many times in the 2000s will return again.

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